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Eligibility as a Debtor Under SBRA

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Subchapter V of chapter 11 was created as part of the Small Business Reorganization Act of 2019 (SBRA) and became effective on Feb. 19, 2020.[1] With SBRA, "Congress intended to streamline the reorganization process for small business debtors because small businesses have often struggled to reorganize under chapter 11."[2] Subchapter V relief was initially available to debtors with less than $2.7 million in debts, but that limit has temporarily been increased to $7.5 million.[3] One significant issue is what debts count for purposes of the debt limitation. In a key decision, Hon. **Thomas J. Catliota** of the U.S. Bankruptcy Court for the District of Maryland recently held that neither lease-rejection damages nor Paycheck Protection Program (PPP) funds count against the eligibility cap.

In *In re Wright*,[4] in denying the U.S. Trustee's motion to strike the debtor's designation as a subchapter V debtor, the court noted that the SBRA was designed to broaden relief available to address small business debt. Thus, "[t]he new Subchapter V ... offers small business debtors a streamlined Chapter 11 procedure that is intended to be less costly and time-consuming than a traditional case. To be eligible for Subchapter V, a debtor[5] must have 'noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition ... in an amount not more than [the applicable debt ceiling].'" Any objection to a debtor's eligibility as a subchapter V debtor must be filed within 30 days after the conclusion of the first meeting of creditors or within 30 days after any amendment to the statement of designation as a subchapter V debtor, whichever occurs later.[6]

The SBRA was based largely on the recommendations of ABI's Commission to Study the Reform of Chapter 11.[7] The Commission specifically considered whether chapter 13 precedents were relevant and concluded that they are not, given the different purposes of the two chapters:

> Most Commissioners strongly rejected the notion of either a standing trustee for SMEs [small and medium enterprises] or a chapter 13-like process for SME cases. These Commissioners noted that small business cases are not simply big chapter 13 cases. They highlighted the structural differences in business cases, including the debtor's contractual relationships with vendors and suppliers and its obligations to customers. SMEs also have employees to consider and operational issues that may complicate their restructuring alternatives.[8]

Hon. **Michelle M. Harner** of the U.S. Bankruptcy Court for the District of Maryland, who prior to taking the bench served as Reporter for the ABI Commission, recently noted:

> Congress contemplated an accelerated process for Subchapter V cases, likely as a means to facilitate quicker and cheaper reorganizations. Congress also expressed, however, significant concern for small business debtors, wanting to provide them with a realistic option for reorganizing and saving their business operations. Evidence of this intent is found not only in public commentary but also, more importantly, in the language of Subchapter V itself.[9]

Because the SBRA provides potentially significant advantages to a debtor, including the sole right to propose a plan, elimination of creditors' committees, elimination of the absolute-priority rule and elimination of the requirement for an impaired accepting class,[10] creditors may decide to contest a debtor's eligibility for SBRA relief, which can lead to disputes regarding whether certain obligations count toward the eligibility debt ceiling.

In *In re PMI*,[11] on the petition date the debtor filed a motion to reject 12 parking garage leases

1 11 U.S.C. § 1181, *et seq.*

2 *In re Penland Heating & Air Conditioning Inc.*, 2020 WL 3124585, at *1 (Bankr. E.D.N.C. June 11, 2020) (*slip op.*) (citation omitted); *see also In re Bonert*, 619 B.R. 248, 252 (Bankr. C.D. Cal. 2020).

3 Subchapter V was originally limited to businesses with total debts below $2.7 million. However, in March 2020, the Coronavirus Aid, Relief and Economic Security Act increased the debt limit to $7.5 million, allowing larger small businesses to qualify. Absent further change, the limit will have reverted back to $2.7 million on March 27, 2021. On or about Feb. 25, 2021, Sens. Dick Durbin (D-Ill.) and Chuck Grassley (R-Iowa) introduced legislation (S. 473) that would, among other things, extend the $7.5 million debt limit for one additional year.

4 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020) (*slip op.*).

5 Section 1182 of the Bankruptcy Code defines a debtor as "small business debtor." The phrase is defined as "a person engaged in commercial or business activities [excluding a person whose primary activity is the business of owning single-asset real estate]." 11 U.S.C. § 101(51D). Courts reviewing whether a debtor is "engaged in commercial or business activities" have interpreted that element broadly. *See In re Wright*, 2020 WL 2193240 (individual debtor who had sold all of his nondebtor business enterprises nevertheless met definition because he was addressing residual business debt); *see also In re Ellingsworth Residential Cmty. Ass'n*, 619 B.R. 519 (Bankr. M.D. Fla. 2020) (nonprofit community association was engaged in commercial or business activities and was eligible to be subchapter V debtor).

6 Fed. R. Bankr. P. 1020.

7 "Proposed Recommendations: Small and Medium-Sized Enterprises (SME) Cases," Final Report of the ABI Commission to Study the Reform of Chapter 11 (2020), *available at* abiworld.app.box.com/s/uzc6yo7dr8lt1g2m4uxs (unless otherwise specified, all links in this article were last visited on Feb. 23, 2021).

8 *Id.* at 293.

9 *In re Trepetin*, 617 B.R. 841, 846 (Bankr. D. Md. 2020). *See also In re Progressive Sols. Inc.*, 615 B.R. 894, 897 (Bankr. C.D. Cal. 2020) ("[A] well-functioning bankruptcy system, specifically for small businesses, allows businesses to reorganize, preserve jobs, maximize asset values and ensure proper allocation of resources.") (citation omitted).

10 *See* 11 U.S.C. § 1191(b).

11 620 B.R. at 548. The authors serve, respectively, as counsel to the debtor, and counsel to certain equityholders, in the *PMI* case.

as of the petition date. After the court authorized the rejection of five leases as of the petition date (the others were rejected as of a later date), a large creditor objected to the debtor's eligibility under subchapter V, arguing, *inter alia*, that the lease-rejections damages[12] should count against the subchapter V eligibility cap.[13] Ruling on this objection, and in the absence of subchapter V decisions, the court initially reviewed chapter 12 and 13 debt limitation eligibility decisions for guidance.[14]

The court noted that other courts have recognized the need to efficiently determine debt eligibility in chapter 12 and 13 cases,[15] and concluded that "Subchapter V presents a similar statutory urgency to resolve eligibility determinations as Chapters 12 and 13."[16] While acknowledging this guidance, the court also noted that subchapter V cases are available to entities with more complex creditor relationships than a typical chapter 12 or 13 debtor.[17] For example, few chapter 13 or 12 debtors have substantial PPP funds or a significant number of commercial leases.[18]

Focusing on lease-rejection claims, the court noted that "[t]he parties dispute whether the lease-rejection claims were contingent as of the petition date."[19] The court noted that under § 365, any decision to assume or reject a lease is expressly subject to court approval.[20] Accordingly, "rejection is not a unilateral, independent process that can [be] accomplished by the debtor alone."[21] Because the order approving lease rejections was not entered until two weeks after the petition date, the lease-rejection claims were contingent obligations until entry of that order.[22] The prerequisites to the debtor's lease rejection of any resulting rejection claims were post-petition events.[23] Therefore, the rejection claims were contingent as of the petition date.[24]

The court also considered whether post-petition events could impact subchapter V eligibility and concluded that like in chapter 13 cases, the answer is "no."[25] The court concluded that excluding lease-rejection damages from the debt ceiling because rejection is a post-petition event meets the statutory directive to consider debts *as of the petition date* and also "has the very real benefit of providing certainty to the process."[26] Further, opening eligibility determinations to post-petition events could hinder the expedited process for which subchapter V was designed and nullify the benefits that Congress intended.[27] Considering the foregoing factors, the court concluded that the lease-rejection claims were contingent as of the petition date and therefore not considered in the debt-limit determination.[28]

Another issue in the *PMI* subchapter V proceeding was whether the debtor's PPP should have counted toward its total pre-petition debts, for purposes of subchapter V eligibility. The debtor argued that such funds should not count because the PPP is really a grant program rather than a loan, and even if it were a loan, the debt amount is contingent and unliquidated as of the petition date because of the PPP program forgiveness feature.

Outside of the subchapter V eligibility issue, several courts have treated PPP funds as grants rather than loans.[29] The PPP "functions like a grant" and "basically provides $349 billion in grants so small businesses can pay their employees."[30] There is no loan underwriting (as there is with other SBA loans), and assuming that the loan proceeds are used as required, the loan will be forgiven.[31] Another court pointed out that the PPP is not a loan program due to "the fact that no underwriting function is anticipated and the fact that the 'loan' will be completely forgiven if the applicant simply uses 75 percent of the loan proceeds to keep its employees employed."[32]

In *PMI*, the debtor also argued that even if the PPP were considered a loan or a debt obligation, it would be an unliquidated and contingent claim as of the petition date because the allowed claim amount, if any, depended on future events, including whether the debtor complied with the applicable regulations and whether it subsequently applied for and obtained loan forgiveness.[33] The creditor argued that the PPP was a loan as evidenced by a promissory note in a fixed amount, and was therefore a noncontingent unliquidated debt as of the petition date.

While acknowledging other bankruptcy court decisions involving PPP funds, the *PMI* court noted that this was the first time that a court was considering, in the eligibility context, "whether the PPP is a noncontingent and liquidated debt as of the petition date."[34] As to the contingent nature of the PPP funds, the court focused on whether all of the events giving rise to the claim had occurred pre-petition or whether liability relied on some future extrinsic event that might not occur.[35] To determine the nature of the PPP funds, the court

12 The Office of the U.S. Trustee joined in this objection with respect to lease rejections. *See* U.S. Trustee's Objs. to Debtor's Designation as a Small Business Debtor Under Sections 101(51D) and 1182(1), *In re Parking Mgmt. Inc.*, No. 20-15026-TJC (Bankr. D. Md. July 6, 2020), ECF No. 142.

13 *In re PMI*, 620 B.R. at 548-49.

14 *Id.* at 550.

15 *Id.*

16 *Id.* at 551.

17 *Id.*

18 *Id.*

19 *Id.* at 552.

20 *Id.* at 552-53.

21 *Id.* at 553.

22 *Id.* (citing *In re TWA Inc.*, 261 B.R. 103, 115 (Bankr. D. Del. 2011) (debtor can only seek assumption or rejection after bankruptcy petition is filed and court approval is required)).

23 *In re PMI*, 620 B.R. at 553.

24 *Id.*

25 *Id.* at 554. *See, e.g., In re Wiencko*, 275 B.R. 772 (Bankr. W.D. Va. 2002); *In re Slack*, 187 F.3d 1070 (9th Cir. 1999) ("The language of the statute clearly states that the amount of the debt is determined as of '*the date of the filing of the petition.*'" 11 U.S.C. § 109(e) (emphasis added)). Courts that have considered this issue have narrowly construed the quoted portion of § 109(e) holding that a bankruptcy court cannot look to post-petition events to determine the amount of the debt.

26 620 B.R. at 554.

27 *Id.*

28 *Id.* at 555.

29 This issue arose because the Small Business Administration (SBA) refused to approve PPP loans to chapter 11 debtors, and if the PPP program is treated as a grant, then the SBA's refusal could constitute discrimination in violation of § 525(a).

30 *In re Gateway Radiology Consultants PA*, Case No.19-04971, Adv. P. No. 20-00330 (Bankr. M.D. Fla. June 8, 2020).

31 Mem. Op., *In re Gateway Radiology Consultants PA*, No. 8:19-bk-04971, Adv. P. No. 20-00330 (Bankr. M.D. Fla. June 8, 2020), ECF No. 14; *see also* TRO at 3, *In re Organic Power LLC*, No. 19-01789, Adv. P. No. 20-00055 (Bankr. D.P.R. May 8, 2020), ECF No. 29 ("[T]he PPP is not a loan program, [but] rather a grant or support program offered by the government to small businesses in financial distress without regard to creditworthiness."); Mem. of Decision at 19, *In re Springfield Hosp. Inc.*, No. 19-10283, Adv. P. No. 20-01003 (Bankr. D. Vt. June 22, 2020), ECF No. 63 ("Both subsidized public housing and the PPP are government grant or support programs aimed at helping people in financial distress.").

32 *See, e.g.*, Opinion and Order at 25, *In re Skefos*, No. 19-29718, Adv. P. No. 20-00071 (Bankr. W.D. Tenn. June 2, 2020), ECF No. 19; *see also* Opinion at 13, *In re Roman Cath. Church*, Adv. P. No. 20-1026 (Bankr. D.N.M. May 1, 2020) ("Unlike PPP loans, the loans to mid-size businesses are intended to be repaid.... [The] Defendant should have read and understood the fundamental differences between the mid-size business loan program (real loans) and the PPP (grants or support payments);" Mem. of Decision at 9, *iThrive Health LLC*, No. 19-25413, Adv. P. No. 20-00151 (Bankr. D. Md. June 8, 2020), ECF No. 24 (referring to PPP as grant).

33 The American Institute of Certified Public Accountants (AICPA) has similarly noted that because PPP funds are forgivable if the proceeds are used as required, a borrower may properly account for PPP funds as a grant, rather than a loan. *See* Ken Tysiac, "AICPA Issues Guidance on Accounting for Forgivable PPP Loans," *Journal of Accountancy* (June 10, 2020), *available at* journalofaccountancy.com/news/2020/jun/forgivable-ppp-loans-aicpa-accounting-guidance.html.

34 *In re PMI*, 620 B.R. at 556.

35 *Id.* (citing *In re Green*, 574 B.R.570, 577-80 (Bankr. E.D.N.C. 2017)).

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reviewed the nature of the PPP funds and the debtor's repayment obligations, if any.[36] Reviewing the PPP program, the court considered the application process, including the application form that recognizes the potential for loan forgiveness.[37] The court also considered the lack of due diligence required, the SBA waiver of typical fees and other basic loan requirements,[38] thus concluding that debt forgiveness was the central purpose of the PPP program.[39] Consequently, as of the petition date, a debtor's repayment liability depends on its use of funds,[40] so the PPP funds represented a contingent obligation as of the date the subchapter V petition was filed.[41]

The court also concluded that the PPP funds did not constitute a liquidated claim as of the petition date.[42] "Liquidated debt" refers to the debt amount, not simply the existence of a debt.[43] Given that the amount of PMI's liability on account of the PPP funding could not be determined as of the petition date, and could turn out to be zero, the "PPP obligation was not liquidated as of the petition date because it was not then known and could not be determined."[44] The court concluded that the debtor's obligation to repay the PPP funds was contingent and unliquidated as of the petition date.[45] Therefore, the PPP debt was excluded from the subchapter V eligibility determination and did not count toward the debt ceiling,[46] which made it unnecessary for the court to address the debtor's other argument: that the PPP is not a loan or a debt obligation at all, but instead a grant.

Conclusion

The SBRA was enacted with small, and relatively less complex, cases in mind. This was certainly true when the debt ceiling was initially set at $2.7 million, but even with the temporarily increased debt ceiling, larger and more complex cases will typically be excluded. However, the exclusion of contingent and unliquidated claims from the debt ceiling — including lease- and contract-rejection claims — opens up the possibility of some large and complex subchapter V cases. There might be cases in which fixed debts are relatively low, but the debtor needs chapter 11 for the purpose of rejecting numerous leases. These cases can be large and complex but still fit within subchapter V eligibility. The prospect of moving quickly through chapter 11 — without a creditors' committee, without filing a disclosure statement, without requiring an impaired accepting class and without the absolute-priority rule — might be very attractive to some debtors. abi

36 620 B.R. at 556.
37 *Id.*
38 *Id.* at 557.
39 *Id.* at 558 (citing "Paycheck Protection Program," U.S. Small Bus. Admin., *available at* sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program).
40 620 B.R. at 558.
41 *Id.* at 559.
42 *Id.*
43 *Id.*
44 *Id.*
45 *Id.* at 555.
46 *Id.* at 559.